How Risky Are Your Stocks?

Description

What is risk? Risk can be many things. An investment can be risky to your neighbour but not to you.

Is the principal safe?

Your neighbour hates the idea of the value of his assets going into the red, even if it's temporary. So, he puts his savings in GICs for fixed income and safety of principal. However, you find GICs risky because their low interest rates can hardly combat inflation and help you maintain purchasing power.

The higher the uncertainty of a stock, the riskier it is

You are fine with the volatility of stocks. However, a stock is riskier if there's higher uncertainty about the outcome of its business performance.

For example, if you're aiming for a 6% rate of return, it's much less risky to invest in a Big Five bank such as **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS) than in, say, a small-cap energy stock, such as **Raging River Exploration Inc.** (TSX:RRX).

Why? Because the bank's earnings are much more predictable and consistent than the small-cap energy company's. As a result, investors should look for a bigger margin of safety when they invest in a higher-risk stock over a lower-risk stock.

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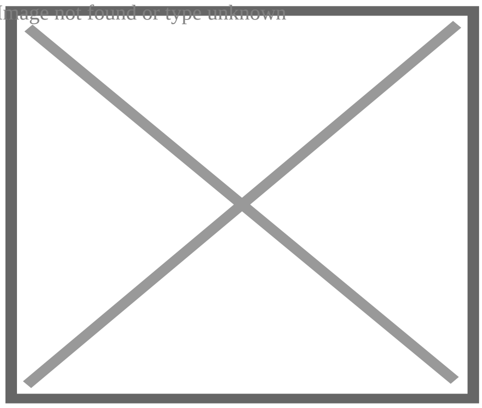

Valuation

For any investment, if you pay too high a price for it, it becomes risky — the investment can deliver poor returns or even have downside risk in the near term or longer.

Ask the folks who bought any of the Nifty 50 stocks in the 1970s or tech companies with stratospheric price-to-earnings multiples during the Internet Bubble in 2001.

For a high-quality company such as Bank of Nova Scotia, which generates stable, growing earnings, some investors may be willing to buy shares at a fair price. However, for a riskier stock such as Raging River, investors might require at least a 30% discount before investing.

Where do the stocks stand today? The Street consensus from **Thomson Reuters** has a near-term target of $86.60 per share for Bank of Nova Scotia and $10.30 per share for Raging River.

At ~$80.70 per share, the bank trades at a ~7% discount, which indicates it's in fair-valuation range. At ~$7.40 per share, Raging River trades at a ~28% discount.

Investor takeaway

Risk is in the eye of the holder. Bank of Nova Scotia and Raging River can both be valid investments for different investors. The bank offers lower uncertainty and reasonable and stable returns, while the energy company can deliver strong returns if oil prices improve.

Typically, the lower the valuation you pay for a stock, the lower risk you'll take, because when stocks trade at low multiples, some of their risks have played out.

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kayng